BRIEFING

Requested by the BUDG Committee

Revamping the EU's budgetary flexibility

In-built flexibility and « in-budget » borrowing

KEY FINDINGS

The high level of uncertainty and the multiple undefined challenges the EU faces require a fair amount of flexibility in the use of EU funds, as well as greater democratic control.

To reduce the need for disorderly ex-post adjustments that are largely responsible for the EU budget's currently opaque governance structure, the long-term EU budget should be endowed with a new type of in-built flexibility.

The following changes may be applied to achieve it: a) a simplification of the MFF architecture; b) a new, non-thematic flexibility instrument over and above MFF ceilings; c) a change in the pre-allocation system with a national flexibility instrument embedded within each national financial envelope (within MFF ceilings); and d) a MFF-embedded anti-cyclical instrument.

These changes would deliver in qualitative terms but probably remain short on the magnitude needed to finance either expensive European public goods and/or special initiatives. This calls for the exploitation of "in-budget" (as opposed to off-budget) borrowing capacity.

The mechanism shall start from the inclusion of a new revenue line in the Own Resource Decision (ORD), a politically and legally challenging option. At the same time, it should come with an explicit borrowing limit, which may soften political resistance, and fresh resources for debt service. It comes with two main advantages: It secures a role for the budgetary authority, hence full democratic oversight, and may avoid that the financing costs of EU borrowing rise for reasons unrelated to fundamentals.

In response to recent successive crises, the EU budget has gone through multiple and incremental adjustments that have created an opaque governance structure constraining both efficiency and democratic oversight.[1] At present, the long-term EU budget appears to be ill-designed to respond both to unforeseen events and to medium- and long-term challenges that will be increasingly determined outside the EU and to which EU governments are unlikely to respond with one voice. This economic and political unpredictability calls for a major rethinking of the general purpose and governance of the long-term EU budget, away from current flexibility arrangements and towards a set-up that consists of two main new elements: in-built flexibility and "in-budget" borrowing capacity.

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1. Limits of current flexibility

The existing flexibility arrangements have allowed some degree of additional flexibility without dramatically changing the operation of the EU budget[2]. Yet, this state of affair has drawbacks: First, ad-hoc flexibility inside a rigid programming structure has led to the inevitable proliferation of instruments and practices that make the economic governance structure opaque and budgetary control rather elusive. Second, the experience of the COVID-19 pandemic shows that, in the presence of a large negative shock, they are unlikely to do the job. The European Union Recovery Instrument (EURI) allowed the EC to borrow against the EU budget guarantee but, as the relevant revenue item consists of externally assigned "other revenues" the decision was not taken in the annual budgetary procedure where the EP is involved as one arm of the budgetary authority by virtue of Art.314 TFEU. Moreover, as Art.122 was chosen as the legal basis, it happened that throughout the process, the EP was merely informed about a policy intervention with massive implications for the EU budget.

To strenghten efficacy, accountability and democratic oversight, two broad remedies are suggested: a) in-built flexibility; and b) the exploitation of "in-budget" borrowing capacity. Both bring the EU budget back under control of the budgetary authority, securing a central role for the EP as co-legislator.

First, carefully designed in-built flexibility would reduce the need for cumbersome ex post adjustment. As the EU is embarking on a structural transformation, exceptional unforeseen circumstances will become the norm, thereby emptying the very notion of extraordinary or crisis-related flexibility, which informs much of the current framework. These considerations are feeding the specific articulation of in-built flexibility, as it will be explained below. Second, as this may still not be able to deliver in quantitative terms, unexploited "in-budget" (as opposed to off-budget) borrowing capacity can still come to the rescue.

2. A new flexibility

2.1. In-built flexibility

It is suggested to achieve in-built flexibility by addressing four aspects of the governance of the EU budget: a) the overall MFF architecture; b) the governance and operation of flexibility instruments above expenditure ceilings; c) the pre-allocation system, whose limits may be addressed through the creation of a flexibility instrument embedded within each national envelope; and d) the introduction of an MFF-embedded anti-cyclical instrument.

2.1.1. The MFF architecture

The architecture of the MFF is here understood as the number of headings and the distribution of spending programmes between headings. There is generally a good degree of flexibility when it comes to shifting resources around within the same (sub)-heading and even across headings provided overall ceilings are respected. Changes to the ceilings however - even if just reshuffling resources - would require a change in the MFF regulation, to be agreed by unanimity within the Council. It is desirable to simplify the MFF structure by reducing to some extent the number of headings and of programmes so as to limit cumbersome re-prioritization and programming and reliance on unanimity, which is politically difficult to achieve.

Obviously, the simplication of the MFF architecture reduces the visibility and the scope for intervention of the EP in all cases in which changes to the original structure would have been agreed within the annual budgetary procedure in the "old" system. This may leave excessive discretion in the hands of the European Commission. There are two possible avenues to counterbalance this price of simplifying the MFF architecture: One is to involve the budgetary authority for any transfer of resources within the MFF, irrespective of thresholds. This requires a revision of the Financial Regulation (Art.30-31). The other is to envisage a strong role for the EP in the governance and operation of the national flexibility instrument (see section 2.1.3).

2.1.2. Special instruments

Special instruments have two features. First, they are largely capped ex ante.[3] Second, to comply with their pre-determined (small) size, some of them come either with a very specific "label" (Solidarity and Emergency Aid Reserve and Brexit Adjustment Reserve) and/or with strict eligibility criteria (e.g. European Globalization Adjustment Fund, henceforth EGF).[4] Size and "label" tend to be two sides of the same coin. Yet, this system creates excessive administrative burden ex ante and often results in a low take-up (e.g. EGF).[5]

To avoid a dispersion of available resources and because, as suggested above, unexpected events will become the norm as the EU economy embarks on a much needed structural transformation, all special instruments should be merged into two non-thematic instruments. One is a flexibility instrument with an endowement agreed in the framework of the MFF negotiation, whose value should be equal to the sum of all pre-existing special instruments except the Single Margin Instrument (SMI) (EUR 7.3 billion per year). The other element is a new SMI that is built up over time just like the current SMI.[6] Yet, the possibility offered under the SMI to carry over previous margins into subsequent years runs against the fact that such margins are small in size to start with because the appropriations entered into the annual EU budget are roughly similar to those secured in the MFF for each year.[7] They have recently further narrowed as resources have been mobilised to cover the higher refinancing costs of EURI, for which in fact a stand-alone financing mechanism should be created.

It is desirable that EU Institutions use the upcoming MFF negotiations to agree on a larger margin between commitment and payment appropriations so as to expand the (new) SMI's capacity. The additional reserves can be fed by means of existing and future de-commitments after harmonization of rules on de-commitments (with the exception of externally assigned revenues). Equally, surpluses from the previous financial year should be treated in the same way and channelled into the new SMI.[8] The figures are non-trivial. The EC is forecasting de-commitments over 2023-2027 to stand at EUR 7.6 billion.[9] The average yearly financial surplus has been of EUR 2,5 billion under the MFF 2014-2020 as well as in 2021-2023. If implemented, this system allows for decommitted appropriations and surpluses to remain in the budget under the EP's scrutiny.

2.1.3. National flexibility instrument

Most EU funds are pre-allocated (ca. 80%). It is desirable to reduce the share of pre-allocated funds within each national envelope. The high uncertainty regarding future socio-economic challenges requires that Member States and regions be left with a level of flexibility that lessens the need for constant re-prioritization and re-programming, which may still be needed even after some simplication in the MFF architecture. Differently from the "new" SMI suggested above, non-pre-allocated national funds should be thematic in nature and aimed at addressing the social consequences of the green and digital transformation.

This new national flexibility instrument implies that a sub-component of each national envelope is activated on demand to support individuals that are either first employed or re-employed in jobs that support the green and digital transition to finance on-the-job training as well as active labour market policies, irrespective of the region of residence. The share of non-pre-allocated funds can vary from one country to the other following the usual criteria employed under cohesion policy.[10] The EU co-financing rate for such instrument should be 100%. No strict eligibility criteria should apply. While these funds are to be managed by the central government and should not follow regional eligibility criteria (differently from the pre-allocated portion of the national envelope), its on-demand nature guarantees that the money goes where it is most needed and, most probably, still within the less developed regions, where the share of green jobs is roughly ¼ of what it is in the more developed regions.[11] Any request for activation should be treated just like calls under the (old) EGF and hence requires the EP's approval. Moreover, the instrument should be embedded in a mid-term and ex-post evaluation framework like Horizon Europe with evaluation reports scrutinised by the EP. Unused funds in one year would be brought forward into subsequent years in the framework of the annual budgetary procedure, thereby securing the EP's scrutiny and oversight.

2.1.4. MFF-embedded anti-cyclical instrument

All the measures suggested above allow for a better response to unforeseen events but are not likely to make a difference in the presence of extremely negative cyclical conditions. In particular, as it is always necessary to align contributions from the Member States with the corresponding needs and a severe economic downturn is making such alignment more difficult, one option would be to implement a system by which the EC borrows on capital markets under EU budget guarantee to generate the liquidity necessary in any given year. The system should be activated on request by one or more Member States. The capital would be paid back in annual instalments as the funds become available through subsequent annual budgets within the same MFF. The details of such a mechanism are provided elsewhere.[12] As such, this would constitute a form of large pre-financing obtained by means of borrowing and in turn a powerful anti-cyclical instrument at times in which Member States remain committed to stringent (albeit reformed and improved) fiscal rules.

3. "In-budget" borrowing capacity

There may still be special circumstances that require activating abundant resources over a short period of time. The EU has unexploited borrowing capacity within the EU budget itself. In the past, the EC borrowed against existing margins (i.e. budgetary headroom) to finance the Medium-Term Financial Assistance (MTFA) and subsequently the European Financial Stability Mechanism (EFSM).[13] As illustrated above, many of the margins are already exploited for potential disbursements and, in any case, their size makes them unfit to respond to either a major shock like the COVID-19 pandemic or extremely negative cyclical conditions.

The main (legal) reason why borrowing could take place in the past under EU budget guarantee was the fact that proceeds from debt issuance can count as revenues under the heading "other revenues" and, as such, debt is not violating the balanced-budget principle enshrined in Art.310(1) TFEU. Still, this only allows for small-scale debt issuance given the magnitude of available margins (e.g. MFTA and EFSM). Moreover, even when larger volumes are allowed through externally assigned revenues (i.e. NGEU), the proceeds cannot finance the general budget. To overcome these constraints, one option would be to create a new revenue line in Art. 2 of the Own Resources Decision (ORD), a legally and politically challenging option that requires unanimity in the Council and ratification by national parliaments. As noted in the legal literature, the ORD would nonetheless need to make the borrowing limit explicit and guarantee debt service via "real" (i.e. non-borrowed) own resources.[14]

Once a new revenue line is created in the ORD, the activation of this borrowing capacity would not depend on the political success of initiatives aimed at raising future own resources. The proceeds may be used for different purposes and do not need to be earmarked. They may finance so-called European public goods such as large cross-border infrastructural projects or for specific purposes included in the primary-law provisions such as cohesion policy support as foreseen in Art. 175 TFEU.

While it carries a "several" (pro-rata) guarantee just like NGEU funds[15], this new vehicle would be superior to them for two main reasons. First and most importantly, it remains within the MFF and hence secures the role of the EP in the framework of the budgetary procedure. Second, it would be a permanent "in-budget" borrowing capacity that may be able to convince investors of the merit of the initiative, avoiding that its financing rise for reasons related to the institutional set-up of the financial instrument, when fundamentals have not changed.

Annex A

Current flexibility arrangements

Flexibility above expenditure ceilings

To respond to unforeseen events , whether of a catastrophic nature or not, the EU can in principle count on common financial resources over and above the agreed expenditure ceilings. These special instruments amount to EUR 21 billion under the MFF 2021-2027 (in 2018 prices). They are divided into thematic (Solidarity and Emergency Aid Reserve, European Globalization Adjustment Fund, and Brexit Adjustment Reserve) and non-thematic (Single Margin Instrument, henceforth SMI, and Flexbility Instrument, henceforth FI). Albeit through different mechanisms, they all come with a predetermined size on top of the overall cap at EUR 21 billion. While thematic instruments and the FI are pre-allocated a fixed amount, the endowment of the SMI is a function of available margins. De facto it allows to shift margins below the MFF ceilings for commitment appropriations and those between MFF payment ceilings and executed payments into subsequent years and, to some extent, across headings.[16] Because of both the pre-definition of purposes (in some cases) and scale (in all cases), these instruments are unlikely to make a difference in case of a significant aggregate negative shock.[17]

Flexibility within expenditure ceilings

Thematic flexibility also applies to specific programmes, whose financing falls within MFF expenditure ceilings. The Neighbourhood, Development and International Cooperation Instrument (NDICI) has a cushion of unallocated funds worth EUR 9.53 billion to be used as a top-up of normal programmes or as a rapid response mechanism. Equally, the Common Agricultural Policy (CAP) has a crisis reserve to respond to serious market disturbances. The Border Management and Visa Policy Instrument (BMVI) and the Asylum, Migration and Integration Fund (AMIF) both have a Thematic Facility, whose funds are allocated to emerging or unforeseen needs either under shared management or direct/indirect management.

There are also procedures and practices other than codified tools that aim at improving flexibility in the use of EU resources and that come with budgetary implications even if they do not require the exploitation of existing margins. They have been extensively used up to now to overcome the limited size of any of the available margins discussed above. They include changes to pre-financing; the use of financial instruments[18]; and changes to the co-financing rate. They are mobilised either individually or in combination in the case of individual countries being under stress (i.e. financial assistance) or once the "general escape clause" is activated[19], should one or more Member States wish so, or towards the financing of priorities defined in the framework of the Strategic Technologies for Europe Platform (STEP), for which indeed generous pre-financing was granted together with a 100% EU co-financing rate.[20]

Recently, cohesion policy was bent to accommodate the need to respond to unforeseen events via successive amendments to the cohesion policy regulation, most notably in the case of CRII, CRII+, CARE, CARE+, FAST-CARE and SAFE).[21]

Procedural flexibility

The EU has been equally resorting to practices that implied a change in the destination and operation of pre-allocated EU funds without financial consequences for either the EU or the Member States. These boild down to re-prioritization and re-programming, which are understood as the practice of transfering resources across programmes (and more easily within programmes). The Financial Regulation specifies allowed transfers and sets thresholds for when the budgetary authority must approve the transfer.[22]

[1] See also ECA (2016), Annual Report, Chapter 2 & Interinstitutional Agreement between the European Parliament, the Council of the European Union and the European Commission (http://data.europa.eu/eli/agree_interinstit/2020/1222/oj).

[2] See Annex A for an overview of current flexibility arrangements.

[3] This is less true of the Single Margin Instrument, whose size is a function of available margins. Still, the overall capacity of special and flexibility instruments is capped ay EUR 21 billions under the MFF 2021-2027 (2018 prices).

[4] Regulation (EU) 2021/691 of the Europran Parliament and the Council of 28 April 2021 on the European Globalization Adjustment Fund for Displaced Workers and Repealing Regulation (EU) N.1309/2013.

[5] Clayes G. and Sapir A. (2018), *The European Globalization Adjustment Fund,* Bruegel Policy Contribution, 5.

[6] Hence, also the non-thematic Flexibility Instrument should be merged into the Single Margin Instrument.

[7] ECA (2018*), Future of EU finances: reforming how the EU budget operates,* Briefing Paper, February.

[8] This requires a change to Art.18 of the Financial Regulation, which states: *"The balance from each financial year shall be entered in the budget for the following financial year as revenue in the event of a surplus or as a payment appropriation in the event of a deficit"*. As in all preceding years, surpluses have always been positive, it is safe to suggest a transfer into the new SMI, whether positive or negative, without prejudice to the instrument itself.

[9] EC, Report from the Commission to the European Parliament and the Council, *Long-term forecast of future inflows and outflows of the EU Budget (2025-2029),* COM(2024), 276 final, 26th June 2024.

[10] The share should be higher for countries whose Gross National Income (GNI) is less than 75% of the EU average GNI.

[11] See https://cohesiondata.ec.europa.eu/stories/s/py4s-5ad4.

[12] Marzinotto, B., (2012), *The long-term EU budget: size or flexibility?* No. 20, Bruegel Policy Contribution.

[13] See Marzinotto, B (2012).

[14] Grund S. and Steinbach A. (2023), *European Union Debt Financing: Leeway and Barriers from a Legal Perspective*, Bruegel Working Paper.

[15] Under the pro-rata guarantee, Member States are liable for their share of common debt issuance (e.g. their share in the GNI-based own resources).

[16] Council Regulation (EU, Euratom) 2020/2093 of 17 December 2020 laying down the multiannual financial framework for the years 2021 to 2027.

[17] The recent extensive use of such instruments has led to the rapid exhaustation of resources, proving their inadequacy. See European Parliament, Budgetary Outlook for the European Union 2024, April 2024.-

[18] They consist of delivery tools such as loans, guarantees, equity or quasi-equity investment channelling EU resources to businesses, in particular Small and Medium Enterprises (SMEs) with the support of financial intermediaries. There are both shared management financial instruments often used to channel resources in the framework of cohesion policy, and centrally managed financial instruments , which are set up by the budgetary authority. See, ECA Special Report (2016), *Implementing the EU budget through financial instruments - lessons to be learnt from the 2007-2013 programme period*, n.19. paragraphs 46 to 54 (http://eca.europa.eu); and ECA Special report (2017), *EU-funded loan guarantee instruments: positive results but better targeting of beneficiaries and coordination with national schemes needed*, n.20 (https://www.eca.europa.eu).

[19] Regulation EU 2021/1060 of the European Parliament and of the Council of 24th June 2021. https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX%3A32021R1060

[20] Regulation (EU) 2024/795 of the European Parliament and of the Council of 29 February 2024 establishing the Strategic Technologies for Europe Platform (STEP), and amending Directive 2003/87/EC and Regulations (EU) 2021/1058, (EU) 2021/1056, (EU) 2021/1057, (EU) No 1303/2013, (EU) No 223/2014, (EU) 2021/1060, (EU) 2021/523, (EU) 2021/695, (EU) 2021/697 and (EU) 2021/241, OJ L, 2024/795, 29.02.2024.

[21] Kiss-Galfalvi et al (2024), *Lessons learned from the implementation of crisis response tools at EU level. Part 1: Assessing implementation and implications*, Study requested by the Cont Committee.

[22] Regulation (EU, Euratom) 2024/2509 of the European Parliament and of the Council of 23 September 2024 on the financial rules applicable to the general budget of the Union (recast) (Art.30-31).

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